

**BEFORE THE INSURANCE COMMISSIONER
OF THE STATE OF CALIFORNIA**

Superior Court Referral of:)	
)	
Williams v. Interinsurance Exchange of the)	
Automobile Club)	
)	File No. OV05049075
(San Diego Superior Court Case No. GIC)	
836845))	
)	
and related litigation.)	

OPINION

INTRODUCTION

On October 6, 2004, Tawndra Williams ("Plaintiffs") filed a class action suit against the Interinsurance Exchange of the Automobile Club ("Interinsurance Exchange" or "Exchange") in the San Diego Superior Court challenging the Exchange's imposition of finance charges on policyholders who paid their auto insurance premiums in installments. The Plaintiffs alleged several causes of action, including violation of California Business and Professions Code §17200, arguing that the Exchange's practice of charging the Plaintiffs more for their automobile insurance than the amount specified in their policies constitutes an unfair business practice because it violates the mandates of California Insurance Code ("CIC") §§ 381 and 383 requiring that the premium be specified in the policy.

A number of other actions have been filed in California courts challenging auto insurers' installment fees. These lawsuits involve the Farmers group of insurers, the State Farm group of insurers, and the Mercury group of insurers. In addition, the Allstate and GEICO insurance groups are defendants in a related multi-state action (including California) pending in New Mexico.

In response to a request by State Farm Mutual Automobile Insurance Company ("State Farm") for an administrative ruling from the Commissioner as to whether "installment service charges are part of the 'premium' for auto insurance within the meaning of the Insurance Code statutes the Commissioner is charged with enforcing," Gary M. Cohen, general counsel of the California Department of Insurance ("CDI" or "Department"), filed a letter brief with the *Williams* court. The October 5, 2005 letter described what the Department considered to be the appropriate exercise of its primary jurisdiction, and indicated that the question of whether installment fees are, or should be, included in premium fell within its regulatory authority.

On October 26, 2005, in response to a motion by the defendant, the Superior Court for the County of San Diego stayed *Williams v. Interinsurance Exchange of the Automobile Club* pending referral of the general issue of whether installment fees constitute premium within the meaning of Insurance Code §381(f) to the California Department of Insurance for disposition pursuant to the primary jurisdiction doctrine.

Upon receipt of the order from the San Diego Superior Court, the Commissioner solicited input from the parties to the related cases on how best to proceed with the referral. The Commissioner asked whether the parties believed an evidentiary hearing was necessary or believed that the issue could be decided on the basis of pleadings and declarations.

Following consideration of the responses to that request, the Commissioner set a briefing

schedule consisting of opening pleadings, responsive pleadings, and oral arguments for all interested parties. The Commissioner heard oral arguments on January 26, 2006 with General Counsel Gary Cohen presiding.

To date, the Commissioner has received and considered briefs (and accompanying exhibits), correspondence, and oral arguments from the plaintiffs in the various actions and from the Interinsurance Exchange, State Farm, Farmers, Allstate, Mercury, and GEICO and their trade associations ("Companies").

DEFINITIONS AND USAGE OF THE TERM "PREMIUM" OUTSIDE THE CONTEXT OF SECTION 381 ARE CONFLICTING AND NOT DISPOSITIVE

The parties involved in these installment fee actions have each characterized the various legal, regulatory, actuarial, and industry authorities as consistently supporting their interpretation of the term "premium," insofar as it includes or excludes installment fees. Each side maintains that the courts, insurance regulators, treatises, and actuarial experts have clearly and uniformly defined the term, leaving no room for alternative meanings.

As set forth in greater detail below, the Commissioner finds that the term "premium" has several different (and sometimes conflicting) meanings depending upon the context in which it is used.

Actuarial Definition. In the actuarial context, in determining the rates and premiums charged policyholders, "premium" generally means "consideration paid an insurer for undertaking to indemnify the insured against a specific peril. The amount of the premium varies in proportion to the risk assumed." *Couch on Insurance* 3d, at 69-5. A similar definition appears in the *Foundations of Casualty Actuarial Science* (4th ed.), at 84: "Application of the rate(s) to the individual exposures to be covered by an insurance policy produces the premium for that

policy.” Were this narrow definition to be applied, installment fees generally would not constitute premium because they are unrelated to the risk of loss and to the basis used to determine cost to the policyholder. This is consistent with Principle 2 of the Statement of Principles Regarding Property and Casualty Insurance Ratemaking of the Casualty Actuarial Society.¹

Accounting/NAIC Principles. The National Association of Insurance Commissioners (NAIC) Accounting Practices and Procedures Manual (specifically Statement of Statutory Accounting Principles (SSAP) No. 53) defines “written premium” as the “contractually determined amount charged by the reporting entity to the policyholder for the effective period of the contract based on the expectation of risk, policy benefits, and expenses associated with the coverage provided by the terms of the insurance contract.”

Contrary to the Companies’ characterization, the NAIC principles do not always “specify that installment fees should be treated separately from premium.” Instead, some installment fees constitute premium and some do not (those not meeting the criteria in footnote 1 to SSAP 53).²

Industry Practices. The Commissioner is aware that the Companies’ practices are not uniform with respect to the treatment of installment fees. The divergence in practice includes when and how the insurers disclose installment charges to policyholders, how much they charge,

¹ Principle 2 states that “[a] rate provides for all costs associated with the transfer of risk.” See <http://www.casact.org/standards/princip/sppcrate.pdf>.

² In this context, the NAIC does not treat many installment fees as premium because they (1) are intended to compensate the insurer for the additional administrative costs associated with processing more frequent billings; (2) have no relationship to the amount of insurance coverage provided or the period of coverage; (3) are unrelated to the lost investment income associated with receiving the premium over a period of time rather than in a lump sum; and (4) have no underwriting risk associated with the additional charge. Under these guidelines, if a policyholder does not pay the installment fee, the policy is not cancelled (unlike non-payment of premium), but instead the policy is converted back to an annual pay plan. If a policyholder cancels coverage, the premium is returned but the installment fee is not, as the fee is not considered to be part of premium.

In addition, although the overall mission of the NAIC is related to protecting the public interest, as the Companies claim, the organization’s accounting practices generally are made to promote the reliability, solvency, and financial

how they treat those fees for purposes of regulatory filings, whether they pay premium tax on the installment charge revenue, and whether policyholders' failure to pay installment fees results in cancellation of their policies for nonpayment of premium.

Gross Premiums Tax Context. In the gross premiums tax context (California Constitution Art. XIII §28 and related code sections), installment fees unrelated to premium financing plans generally have been included in the California courts' and state regulators' definition of "gross premiums." See discussion of related case law below.

Objective Guidelines for Rating. Under Title 10, Section 2360.0 of the California Code of Regulations, premium is defined broadly to include the "final amount charged to an insured for insurance after applying all applicable rates, factors, modifiers, credits, debits, discounts, surcharges, fees charged by the insurer and all other items which change the amount the insurer charges to the insured." Installment fees presumably would be included in this expansive definition of premium. See additional discussion of 10 CCR §2360.0 below.

Legislative Intent of California Insurance Code §381(f). In spite of arguments to the contrary, the legislative history of §381 is not instructive. Nothing in this history describes or illustrates the items to be disclosed as premium.

KEY ISSUES RAISED BY THE PARTIES AND THE COMMISSIONER'S RESPONSE

The parties have discussed at considerable length what the terms "premium", "rates and premium," or "gross premiums" mean in the context of other statutes besides the section at issue in this case. The Commissioner does not find such discussions particularly helpful because the purpose of these statutes is manifestly different than the purpose of CIC §381 as discussed elsewhere in this decision. Nevertheless, the Commissioner has discussed these other sections in

solidity of insurance institutions, rather than to promote the type of transparency covered by §381.

an attempt to provide technical guidance to the court and to shed further light on their meaning.

The Commissioner's Treatment of Installment Fees for Rate Calculations

The treatment of installment fees in the Commissioner's rate approval regulations, Title 10 §§2641.1 *et seq.*, adopted pursuant to CIC §§1861.01, *et seq.*, further illustrates the ambiguity with regard to whether installment fees should be treated as premium.

Broadly speaking, these “rate approval” regulations create a mathematical formula into which the insurers' losses, expenses and income, along with a profit factor, are used to calculate the minimum and maximum aggregate (total for all its policyholders) premium that an insurer may charge. In the fall of 2004, to ensure that rate applications were processed on a uniform basis, the Department determined that it would classify the income derived from flat-fee installment fees as premium. Previously, some analysts put such installment fees into the ancillary income portion of the formula, while others put it into premium.

With respect to interest-based installment fees, such as those charged by the Exchange, the analysts were instructed to categorize the portion that is designed to reimburse the insurer for the administrative expense of providing an installment fee option as premium and the remaining portion (regarded by the insurers as compensation for lost investment income or other profit) as ancillary income.

These directions notwithstanding, the Department continued to use the previous classifications (e.g., treating flat-fee installment fee income as ancillary income) in some cases, even after 2004.

Nevertheless, even if *all* of the rate analysts uniformly had treated installment fees as premium or ancillary income when performing their rate calculations, the parties, especially the

Companies, place too much emphasis on its significance in the context of this case. The issue in this case is to interpret what premium means in the context of CIC §381, not its meaning under regulations promulgated pursuant to CIC §§1861.01 *et seq.* The primary purpose of CIC §1861.01 *et seq.*, in the context discussed by the Companies, is to make sure that rates are not excessive, inadequate, or unfairly discriminatory. The purpose of CIC §381, as discussed elsewhere, is to make sure there is full disclosure of both the terms and costs of the insurance policy.

“Auto Rating Factor” Statute

The Companies take the position that another significant problem with the plaintiff’s theory relates to §1861.02(a)(4), which requires that in addition to the three mandatory rating factors,³ rates and premiums for auto insurance can be determined only by optional rating factors that have a substantial relationship to the risk of loss and which have been adopted by regulation. However, like the rate approval regulations adopted under CIC §1861 *et seq.*, this statute is also addressing the term “premium” in a narrow actuarial context that is different than the purpose behind 381(f). *See* discussion below.

Treatment of Installment Fees in California Automobile Assigned Risk Plan and Low Cost Automobile Insurance Program

In their briefs, oral argument and correspondence, the Companies point to the basis for

³ Under Proposition 103 (CIC §1861.02): “(a) Rates and premiums for an automobile insurance policy . . . shall be determined by application of the following factors in decreasing order of importance: (1) The insured’s driving safety record. (2) The number of miles he or she drives annually. (3) The number of years of driving experience the insured has had. (4) Such other factors as the commissioner may adopt by regulation that have a substantial relationship to the risk of loss. The regulations shall set forth the respective weight to be given each factor in

the rates and the application form for the Low Cost Automobile Insurance (LCA) program and California Automobile Assigned Risk Plan (CAARP), which do not include installment fees in the "total policy premium" figure, as further evidence that installment fees are distinct and separate from premium.

Plaintiffs respond that CIC §381 applies to all lines of insurance and the definition of the term "premium" must harmonize across all those lines. For that reason, they maintain that like the Proposition 103 "rate approval" regulations, the LCA program and CAARP, which are narrower in scope than CIC §381, are irrelevant here.

Again, the Companies' argument focuses on premium from an *actuarial* perspective, rather than premium for the purposes of CIC §381. Since the purposes of the statutes differ, it is not surprising or problematic that they may use the term "premium" differently. The Companies make a similar argument themselves when they contend that Plaintiff's use of the premium tax cases (discussed in greater detail below) should not control how that term is used in CIC §381. They point out that the *purposes* of California Constitution Article XIII §28 and related code sections (i.e., determining insurers' tax basis) are different from the *purposes* of CIC §381 (i.e., informing policyholders of the terms and cost of the policy), and CIC §383.5 (i.e., elaborating on the meaning of CIC §381 for motor vehicle insurance purposes).

Section 383.5 Requirements

The Companies argue that treating installment fees as premium would lead to serious inconsistencies with CIC §383.5, which states that an insurance policy "shall conform to 381 and shall segregate the premiums charged for each risk insured against." According to the

determining automobile rates and premiums. Notwithstanding any other provision of law, the use of any criterion without such approval shall constitute unfair discrimination."

Companies, since the installment fees do not vary by risk, they cannot be broken down in accordance with this statute, and this compels a conclusion that installment fees are not part of the premium required to be disclosed under CIC §381(f).

Plaintiffs respond that installment fees can be included in premium at the initial rate making stage, but ultimately charged only to policyholders who pay via installments. They claim that insurers could treat such fees as they do other types of “optional” insurance coverage, such as emergency roadside assistance. They further maintain that it is illogical for the “optionality” of installment fees to affect their classification as premium.

The Commissioner agrees that the inclusion of installment fees as premium under CIC §381(f) does not preclude their being charged under the requirements of CIC §1861.01 *et seq.* only to policyholders who pay via installments.

The Companies’ argument ignores the basic purpose of §383.5, which is to prevent fraud or mistake. This statute provides a further disclosure of premium than originally required under CIC §381(f). The Commissioner believes this evidences an intent to provide more useful information to insureds about the nature and cost of the policy. The risk-based breakdown the Companies claim the statute requires is therefore a means to that end, not an end in itself, which presumably is why the Legislature expressly gave the Department the authority to promulgate rules and regulations to prevent further mistake or fraud.

Regulatory Consistency

The Companies argue that it is important that the regulatory terms in the Insurance Code have a consistent meaning for the sake of administrative fairness and predictability. They argue that the Department’s longstanding practices concerning enforcement and interpretation of §381

have created “de facto” regulations that the insurers have relied upon. As support, they point to the Department’s field rating and underwriting examinations that have not objected to insurers’ declaration pages excluding installment fees under the definition of premium and have determined that the disclosed premium be a premium that results from the approved rate.

In response, Plaintiffs argue that the Companies are taking the untenable position that they may not be complying with the law, but the Department is responsible for their lack of compliance with §381(f). They also point to the holding in *Department of Mental Hygiene v. McGilver*, 50 Cal. 2d 742, 752 (1958), which states that “[m]ere failure to enforce the obligation cannot be deemed to constitute such administrative action as would result in modifying, remitting or canceling the obligation, constructively or otherwise.”

In responding to the referral from the Superior Court, the Commissioner is not called upon to decide the outcome of these cases. Nor is he asked to decide what effect, if any, the fact that some Companies have relied, at least to some extent, on the Department’s field rating and underwriting examinations and ratemaking classifications in excluding installment fees from their definition of premium in the policies they issued should have on the outcome of these cases. Instead, he is called upon to answer the question referred by the Court: “Whether installment fees are premium as that term is used in Insurance Code Section 381(f).”

In answering this question, the Department’s past practice, and parties’ reliance on it, may or may not be instructive, but it cannot be determinative. The Commissioner’s task is to provide the Court with the best-reasoned analysis of the question presented.

Gross Premiums Tax Cases

Plaintiffs cite to decisions by the California courts,⁴ the Commissioner,⁵ and the Department of Justice⁶ in support of a broad definition of premium, arguing that these decisions consistently support their position. They maintain that those courts examined principles of insurance law, not tax law, in holding that charges for these billing and collection expenses generally are premium. Plaintiffs argue that "costs are costs and income [is] income" and that premium is the "income received by the insurance company to cover the cost of insurance."

Companies respond that the cases upon which Plaintiffs rely are inapposite because none consider the question referred by the San Diego Superior Court: whether installment fees are premium under §381(f). They claim that the cited cases define premium in a narrow tax context in which the courts sought to capture the full extent of the benefit received from being permitted to do business in the state.

Interestingly, Plaintiffs, who have argued before the Commissioner that premium is everything an insured pays for insurance and that the courts have held "without exception that installment charges and similar fees and expenses are premium" cite to *Mercury Casualty* as support for their interpretation of §381(f). In that case, the insurer was able to structure its

⁴ *Allstate Ins. Co. v. State Bd. of Equalization*, 169 Cal. App. 2d 165 (1959); *Groves v. City of Los Angeles*, 40 Cal. 2d 751 (1953); *In re Imperial Ins. Co.*, 157 Cal. App. 3d 290 (1984); *Industrial Indem. Exchange v. State Bd. of Equalization*, 26 Cal. 2d 772 (1945); *Interinsurance Exchange v. State Bd. of Equalization*, 156 Cal. App. 3d 606 (1984); *Mercury Casualty Co. v. State Bd. of Equalization*, 141 Cal. App. 3d 43 (1983); *Metropolitan Life Ins. Co. v. State Bd. of Equalization*, 32 Cal. 3d 649 (1982); *State Comp. Ins. Fund v. McConnell*, 46 Cal. 2d 330 (1956); and *State Farm Mut. Auto Ins. Co. v. Carpenter*, 31 Cal. App. 2d 178 (1939).

⁵ Bulletin 137, which was issued by the Insurance Commissioner in 1953 in connection with surety insurance, included various fees within its definition of premium under §381. Plaintiffs point to language in the Bulletin that says "the full amount paid by or on behalf of the principal (the insured) is the premiums [sic] for the undertaking of bail. . ." as further support for its interpretation.

The Companies respond that the Bulletin supports their interpretation of §381 because it does not consider charges levied by bail agents for additional services to be premium. They argue that the Bulletin draws a distinction between expenses that are part of the transfer of the risk insured against, which must be included in the rate and premium, and separate services not normal incidents of the insurance, which do not.

The bulletin was primarily written to address the tax treatment of installment fees in the wake of *Groves, supra*.

⁶ 9 Ops. Cal. Atty. Gen. 257 (1947) and 58 Ops. Cal. Atty. Gen. 768 (1975).

installment plans such that even though it collected the installment fees from its policyholders, the fees were not considered premium for purposes of the gross premiums tax.⁷

Thus, if the tax cases' definition of gross premiums were applied to §381(f), the illogical consequence might be that flat-fee installment fees would have to be listed as premium on the declarations page, but certain interest-based fees associated with insurers' installment or premium financing plans that meet the criteria of *Mercury Casualty* would not.⁸

As stated above, the Commissioner believes that the above-cited tax cases are inapposite here because they construe the definition of "gross premiums" under Section 28 of Article 13 of the California Constitution and the related code sections (e.g., Insurance Code §1530 and Revenue and Taxation Code §12221), which has a specialized meaning and is intended to serve a completely different purpose (i.e., determining insurers' tax basis) than the term "premium" in §381(f) (i.e., protecting policyholders by disclosing the terms and cost of the insurance policy).

California Insurance Code Section 381 Disclosure Requirements

Finally, Plaintiffs argue that CIC §381(f) should be interpreted to include installment fees because §381 is a consumer protection statute designed to prevent fraud and mistake on the part of the insured. They take the position that §381 accomplishes this objective by listing a number of the pertinent terms and conditions of the insurance contract, such as the parties, the risk insured, the term of the insurance and the money paid for that insurance, also known as the premium.

⁷ Plaintiffs and State Farm have characterized *Mercury Casualty* as holding that an insurer need not include the portion of installment fees that represent interest from a premium financing plan in its tax basis because such interest constitutes investment income.

⁸ Ironically, the interest-based installment fees can be significantly higher than the flat-fee ones. It is also noteworthy that the Exchange, which has repeatedly argued during this proceeding that the tax cases relied on by Plaintiffs are irrelevant and that the "tax treatment of something does not control its treatment for insurance

Plaintiffs contend that the cost of insurance to a consumer is one of the fundamental terms of the contract, more important than technical distinctions between various component parts of premium. The Plaintiffs take the position that consumers need to know with clarity and precision the amount they are required to pay for insurance coverage, which requires insurers to use a uniform definition of premium.

Plaintiffs take the position that many policyholders do not have the ability to pay their policies in full and, therefore, have no choice but to pay in installments; accordingly installment fees constitute a cost of insurance. They argue that it is not fair to allow the insurance companies to determine the time and the manner in which these essential contract terms will be included, and that any rule permitting the industry's current and inconsistent practice regarding specification (or non-specification) of installment charges poses a risk of mistake and an opportunity for fraud, thereby subverting the purpose of §381(f).

The Companies counter that they or their agents clearly disclose payment options with policyholders when they apply for or pay for coverage, and subsequent bills also disclose the amount of installment fees. They add that including installment fees with premium would not provide any protection to consumers, but would only serve to confuse them.

The Companies further argue that installment fees do not constitute premium because the fees are not paid to procure the indemnification contract; instead, installment fees are paid for the privilege of paying premium over time. In support of this argument, the Companies point out that there is no contractual obligation to offer installment fees and that CIC §480 states that "[a]n insurer is entitled to payment of the premium as soon as the subject matter insured is exposed to the peril insured against." They further argue that this is a common-sense distinction between

regulatory purposes," previously argued (before the Superior Court in this matter) that one of those tax cases, *Mercury Casualty, supra*, controlled and justified the granting of its demurrer.

the charges you have to pay to procure insurance and optional charges for payment flexibility.

CONCLUSION: INSTALLMENT FEES ARE PREMIUM UNDER §381(f)

Section 381 requires a policy to recite certain fundamental terms of an insurance contract and ensures that the parties understand the terms and costs. Section 381(f) concerns the consideration or premium to be paid by the insured. As Plaintiffs have underscored, of all contract terms, policyholders generally are most concerned about the bottom line: the total amount they must pay to obtain insurance coverage. And since many policyholders do not have the option of paying in full and installment fees may be a significant addition to the cost of an insurance policy, installment fees represent an integral part of their premium payment.

Further, the primary purpose of §381 (as specifically stated for the automobile line of insurance in §383.5) is to prevent fraud and mistake by requiring insurers to list the basic terms of the contract. Accordingly, it is the Commissioner's view that policyholders would be less likely to be defrauded or mistaken about the amount of premium if that term is defined in the broadest sense, in the typical way policyholders view their installment payments (i.e., the total price of obtaining coverage, including the installment fee). If that overall price varies depending on the existence of an installment fee, a policyholder will be less likely to be mistaken about the cost of insurance if the policy discloses the nature and amount of that variation.

This interpretation is consistent with 10 CCR §2360, set forth above, which was promulgated to make certain that insurance companies charge policyholders the lowest available price for insurance coverage. For such a figure to be meaningful, the regulation uses a liberal definition that includes "all other items which change the amount the insurer charges to the insured," which would presumably include installment fees. The same reasoning applies here.

In sum, the purpose of §381 was not to calculate rates, determine tax liability, or assess the financial solvency of insurers, but to mandate the disclosure of material insurance contract terms, including the price. For the above reasons the Commissioner concludes that installment fees are premium under §381, in the private passenger automobile context.

The Commissioner is giving consideration to promulgating regulations and/or proposing legislation to clarify what charges must be disclosed under premium and to address other issues raised by this referral.

Dated: April 25, 2006

JOHN GARAMENDI
Insurance Commissioner

By: 

GARY M. COHEN
General Counsel

PROOF OF SERVICE
Williams v. Interinsurance Exchange of the Automobile Club
Case No. OV05049075

I am over the age of eighteen years and am not a party to the within action. I am an employee of the Department of Insurance, State of California, employed at 45 Fremont Street, 19th Floor, San Francisco, California 94105. On April 26, 2006, I served the following document(s):

LETTER TO HONORABLE PATRICIA Y. COWETT; OPINION

on all persons named on the attached Service List, by the method of service indicated, as follows:

If **U.S. MAIL** is indicated, by placing on this date, true copies in sealed envelopes, addressed to each person indicated, in this office's facility for collection of outgoing items to be sent by mail, pursuant to Code of Civil Procedure Section 1013. I am familiar with this office's practice of collecting and processing documents placed for mailing by U.S. Mail. Under that practice, outgoing items are deposited, in the ordinary course of business, with the U.S. Postal Service on that same day, with postage fully prepaid, in the city and county of San Francisco, California.

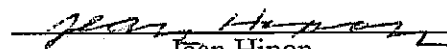
If **OVERNIGHT SERVICE** is indicated, by placing on this date, true copies in sealed envelopes, addressed to each person indicated, in this office's facility for collection of outgoing items for overnight delivery, pursuant to Code of Civil Procedure Section 1013. I am familiar with this office's practice of collecting and processing documents placed for overnight delivery. Under that practice, outgoing items are deposited, in the ordinary course of business, with an authorized courier or a facility regularly maintained by one of the following overnight services in the city and county of San Francisco, California: Express Mail, UPS, Federal Express, or Golden State overnight service, with an active account number shown for payment.

If **FAX SERVICE** is indicated, by facsimile transmission this date to fax number stated for the person(s) so marked.

If **PERSONAL SERVICE** is indicated, by hand delivery this date.

If **INTRA-AGENCY MAIL** is indicated, by placing this date in a place designated for collection for delivery by Department of Insurance intra-agency mail.

Executed this date at San Francisco, California. I declare under penalty of perjury under the laws of the State of California that the above is true and correct.



Jean Hipon

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Case No. OV05049075

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